



Natural Resources
Canada

Ressources naturelles
Canada

Deputy Minister

Sous-ministre

Ottawa, Canada
K1A 0E4

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MEMORANDUM TO THE MINISTER

ANALYSIS OF RECENT STUDIES OF DUTCH DISEASE IN CANADA

(Information)

SUMMARY

- Recently, there has been significant discussion on the extent to which the Canadian economy suffers from the so-called "Dutch disease." The concept comes from a 1977 article in *The Economist* that linked the decline of the Netherlands' manufacturing sector to the discovery of natural gas.
- Based on a number of recent studies, as well as discussions with Finance Canada, the decline in the manufacturing sector over the past decade is best explained by: the global displacement of manufacturing from developed nations to emerging economies; and the poor productivity performance of the Canadian manufacturing sector relative to the United States' (U.S.) and other G-7 countries' performance.
- The Canadian situation is similar to other developed countries, where the manufacturing sector's relative importance is also declining. However, in contrast to Australia and the U.S., Canada's manufacturing sector has experienced a decline in absolute terms between 2000 and 2010. During the same period, Canada's labour productivity in the manufacturing sector grew by only 0.9 percent annually, compared to 4.4 percent in the U.S. The manufacturing sector's investment in machinery and equipment declined from 87 percent of the U.S. level in 1987 to 79 percent in 2009.

BACKGROUND

The term "Dutch disease" was coined in a 1977 article in *The Economist* that linked the decline in the Dutch manufacturing sector in the 1960s and 1970s to the discovery and development of large gas reserves. The article argued that the booming natural resource sector pushed up the currency, making the manufacturing sector less competitive.

A number of recent studies and commentaries in Canada attempt to explain the linkages among: the sharp increase in oil prices over the past decade; the appreciation of the Canadian dollar; and the contraction in the manufacturing sector, especially since 2002 (see Graph 1, Attachment 1). The key facts are:

- commodity prices more than doubled between 2002 and 2011; according to the Bank of Canada commodity price index, commodity prices increased by 122 percent while energy prices increased by 161 percent;
- the Canadian dollar appreciated by more than 50 percent relative to the U.S. dollar between 2002 and 2011; and
- the Canadian manufacturing sector experienced a decline between 2000 and 2011 (see Graph 2, Attachment 1), with its share of gross domestic product (GDP) sliding from 19 percent in 2000 to 13 percent in 2011. Manufacturing real GDP decreased by 1.6 percent at annualized rates over the decade. Employment in the sector declined by 571,550 (or 28 percent) between 2000 and 2011, with Ontario and Quebec accounting for the majority of the reduction.

CONSIDERATIONS

A number of experts, including Finance Canada and the Bank of Canada, as well as economists such as Mr. Jack Mintz¹, argue that Canada does not suffer from the Dutch disease. Instead, more fundamental factors are at play, including:

- Canada's strong economic fundamentals: Canada's economic fundamentals are strong relative to the U.S. and Europe, including: a healthy fiscal position; resilient economic growth; and a strong, sustainable banking system. These make Canada an attractive destination for investment and strengthen the Canadian dollar. As the Governor of the Bank of Canada noted, "the level of the currency is not just about commodity prices, it also reflects some of the underlying strengths in this economy, which are numerous."
- Displacement of manufacturing activity: There is a global trend towards the displacement of manufacturing activity from developed countries to emerging economies, particularly China. While China's share of global manufacturing increased from 10 percent in 2000 to 19 percent in 2010, Europe saw its share drop from 34 percent to 26 percent, while the U.S. saw a decline from 22 percent to 20 percent. A March 2012 article by Mr. Mintz in the *Financial Post* states that

¹ *Financial Post*, Mr. Mintz, *No Dutch disease here*, March 2, 2012.

the situation of Canada's manufacturing sector is not directly related to the higher dollar and that "Ontario's falling manufacturing sector matches the Ohio and Michigan experience." Instead, Mr. Mintz attributes the decline to a shift to emerging economies and "bad management practices and high labour cost."

- Low productivity growth: Ongoing low productivity growth in Canada's manufacturing sector made it highly vulnerable to variations in the exchange rate. Canada's labour productivity in the manufacturing sector grew by only 0.9 percent annually during the 2000–2008 period, compared to 4.4 percent in the U.S. (see Graph 3, Attachment 1). This poor performance is explained by a lack of productivity-enhancing investment during the past 20 years in key areas (e.g. machinery, information and communications technologies, innovation, market development, management practices, etc.). The manufacturing sector's investment in machinery and equipment declined from 87 percent of the U.S. level in 1987 to 79 percent in 2009 (see Graph 4, Attachment 1). This lag, against the backdrop of the global shift in manufacturing to emerging economies, has reduced the competitiveness of the sector, independent of the Canada–U.S. exchange rate.

The view that the value of the Canadian dollar and the performance of the manufacturing sector are driven by natural resources is overly simplistic. For example, a May 2012 study by academia², including Dr. Serge Coulombe, a University of Ottawa professor, estimates that the weakness of the U.S. dollar has been the driving factor over the 2002–2007 period, explaining 58 percent of the appreciation of the Canadian dollar.

In addition, most manufacturing subsectors have adjusted to a higher dollar. According to an Institute for Research on Public Policy's (IRPP) study released in May 2012³, only 25 of the 80 manufacturing subsectors (accounting for about 25 percent of total manufacturing output) show a significant negative relationship between the exchange rate and output. The effects are most pronounced in three small labour-intensive industries (i.e. textiles, apparel and leather), which together account for only two percent of manufacturing output.

Through the recent commodity boom, Canada's economy has outperformed many other economies. According to Budget 2012, Canada recorded the best performance of the G-7 countries during the recession and subsequent recovery. Compared to its pre-recession peak, Canada's real GDP has grown by around three percent, compared to a decline of

² Michel Beine, Charles Bos, Serge Coulombe, *Does the Canadian Economy Suffer from Dutch Disease?*, May 2012, forthcoming in *Resource and Energy Economics*.

³ IRPP (M. Shakeri, R. Gray, J. Leonard), *Dutch Disease or Failure to Compete: A Diagnosis of Canada's Manufacturing Woes*, May 18, 2012.

around two percent for the rest of the G-7 countries. Canada has also posted the strongest growth in employment in the G-7 countries, with growth of more than seven percent over the 2006–2011 period, compared to an average of slightly more than one percent for the other G-7 countries.

In fact, Canada's manufacturing sector has been one of the leading sectors in the recovery. Since 2009, manufacturing GDP grew at an annualized rate of 3.8 percent, compared to 3.0 percent for the whole economy. Manufacturing shipments, which declined 28 percent during the recession, are now only 6.2 percent below their pre-recession peak. In addition, labour productivity has been improving. It is now growing at a rate of 3.3 percent, compared to 1.4 percent prior to the recession.

CONCLUSION

There is no compelling evidence that directly links in a significant way the decline of the Canadian manufacturing sector to rising oil and other commodity prices and appreciation of the Canadian dollar relative to the U.S. dollar. Rather, existing research and analysis point to a variety of factors, namely: Canada's strong economic fundamentals; the displacement of manufacturing activity from developed to emerging economies; and the lagging productivity performance in the manufacturing sector relative to the U.S., which includes underinvestment by Canadian businesses in productivity-boosting areas.



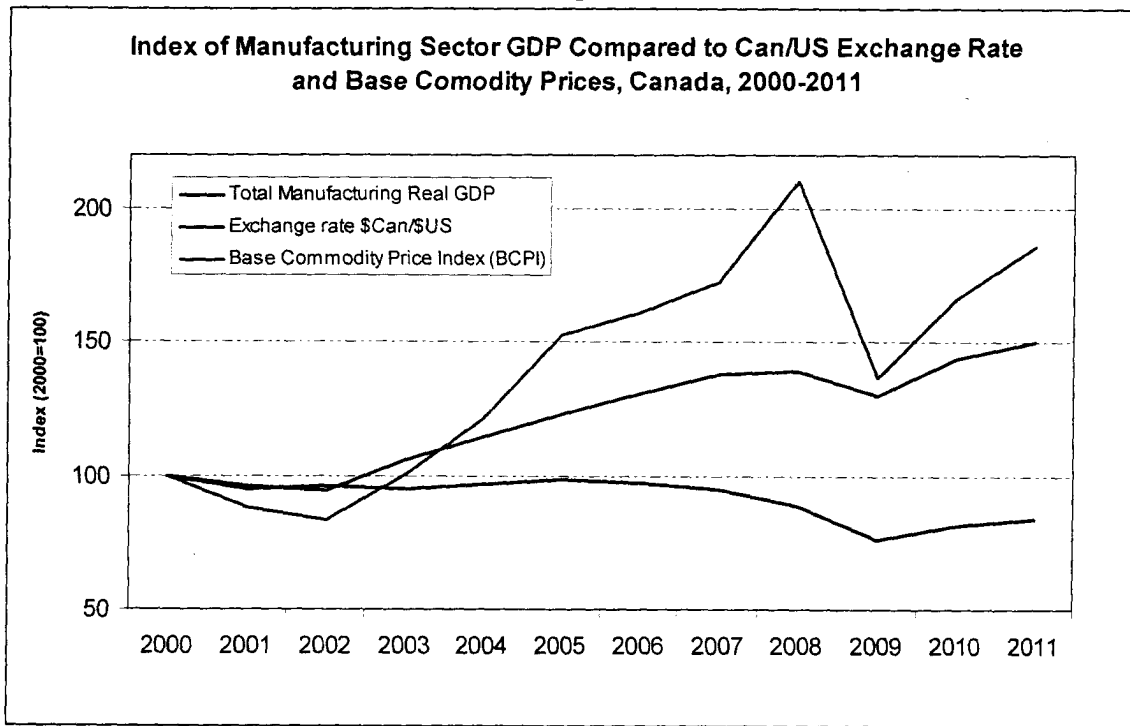
Serge P. Dupont

s.21(1)(a)

Attachment: (1)

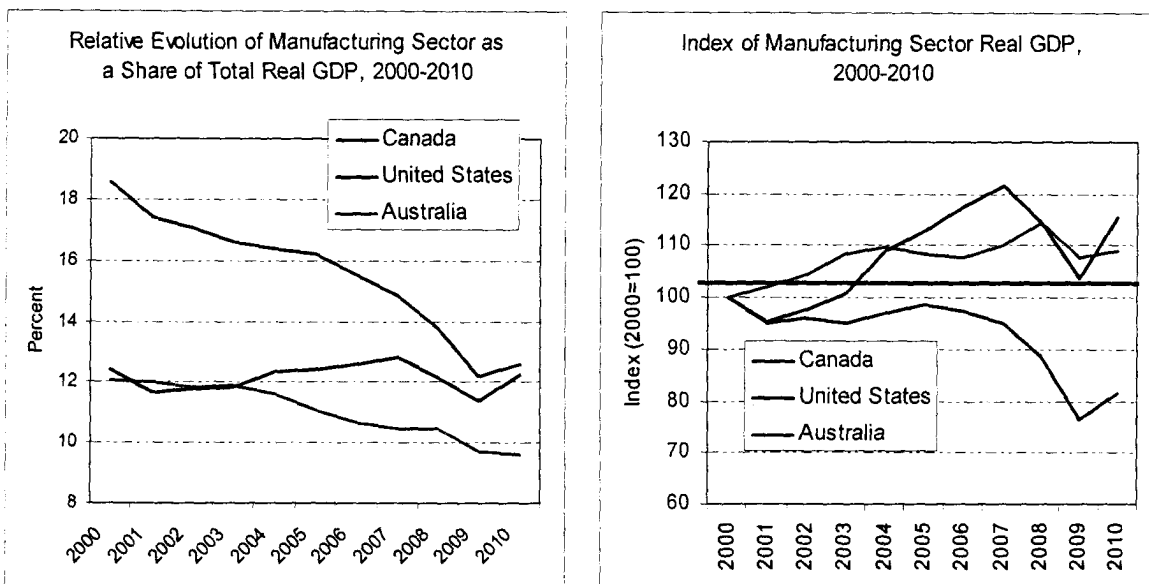
Contact: John Walsh, 613-992-3258
SPEA, Science and Policy Integration Sector

Graph 1



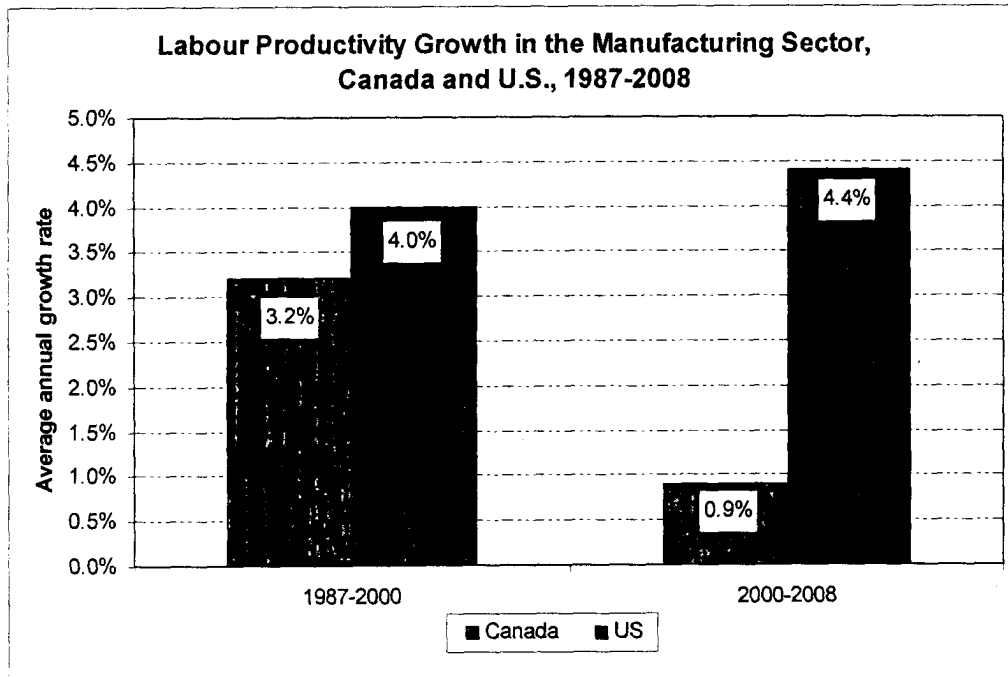
Source: Statistics Canada and Bank of Canada

Graph 2

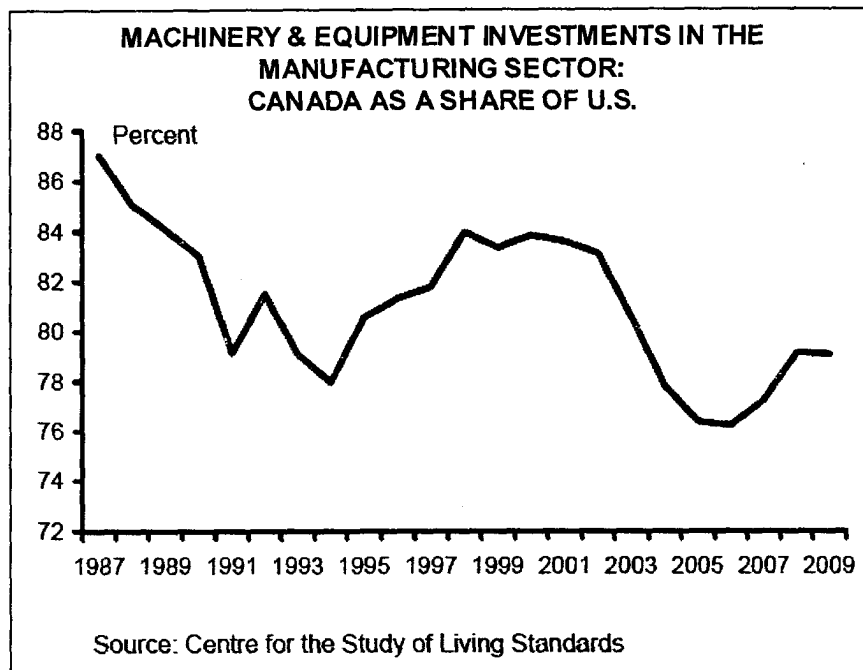


Source: Statistics Canada, Bureau of Economic Analysis (US) and Australian Bureau of Statistics

Graph 3



Graph 4



Source: TD Economics

Docket / Dossier N12-131044

☒ Internal / Internal ☐ External / Externe

Purpose / But Signature ☒ Information Decision / Approval
Décision / Approbation

Recommendation
Recommandation Other / Autre

For / Pour ☒ Minister / Ministre Deputy Minister / Sous-ministre

Associate DM
Sous-ministre déléguée Other / Autre

Sector / Secteur SPI Contact Kathleen Lemire Due Date /
(name/nom - tel.) 992-4451 Échéance April 3 (ADMO)

Subject / Objet JACK MINTZ'S ARTICLE IN THE FINANCIAL POST ON DUTCH DISEASE IN
CANADA

Priority / Priorité
(If urgent, state reason / deadline – Si urgent, donner la raison / date limite)

Sector Consulted – Secteur consulté

AECL Restructuring / Restructuration d'EACL

Audit Branch / Direction de la vérification

Canadian Forest Service / Service canadien des forêts

Corporate Management and Services / Secteur de la gestion et
des services intégrés

Earth Sciences Sector / Secteur des sciences de la Terre

Energy Sector / Secteur de l'énergie

Innovation and Energy Technology Sector / Secteur de
l'innovation et de la technologie énergétique

Public Affairs and Portfolio Mgt Sector / Secteur de la gestion des
affaires publiques et du portefeuille

Science and Policy Integration / Intégration des sciences et des
politiques

Other / Autre

Date

Director / Directeur

Director General / Directeur général

Assistant DM / Sous-ministre adjoint

Comments / Commentaires

3/4/2012